

Benefit Insights



190 North Wiget Lane, Suite 125
Walnut Creek, CA 94598
925.932.1800
www.stollerco.com

Specializing in Custom Retirement Benefit Plans since 1976

A non-technical review of qualified retirement plan legislative and administrative issues

December 2016

Rules and Taxation of 401(k) Plan Distributions

A 401(k) plan permits employees to defer a portion of their salaries on a pre-tax basis with the objective of accumulating assets for retirement. Additional assets are accumulated if the employer makes contributions to the participant's account.

With today's mobile workforce, many distributions are made before retirement because employees usually become eligible to receive distributions when they terminate employment. Distributions also become payable due to disability, death or a Qualified Domestic Relations Order (QDRO). In addition, many 401(k) plans permit hardship withdrawals. Sometimes active participants are forced to take minimum distributions after reaching age 70½.

This newsletter will examine the rules and tax consequences associated with the various types of distributions from a 401(k) plan.

Rollover vs. Cash Distribution

Distributions from 401(k) plans are generally made in a lump sum, although some plans permit participants to elect installment payments or an

annuity. If the distribution is eligible for rollover, the participant can avoid immediate taxation by rolling it over to a traditional IRA (not a Roth IRA) or another qualified plan. Distributions eligible for rollover include:

- Lump sum payments to terminated participants (including disabled or retired);
- Death benefits paid to a beneficiary;
- QDRO distributions to a spouse or former spouse;
- In-service distributions unless made on account of hardship; and
- Installment payments over a period of less than ten years.

Distributions ineligible for rollover include:

- Age 70½ required minimum distributions;
- Hardship distributions from all accounts;
- Corrective distributions due to failed nondiscrimination tests or exceeding legal limits;
- Loans treated as distributions; and
- Installment payments of ten years or more or over the life expectancy of the participant or the joint lives of the participant and beneficiary.

The portion not directly rolled over and distributed in cash is taxed in the year received and is generally subject to mandatory federal income

accounts. Safe harbor employer contributions are not available for in-service distribution prior to age 59½.

IRS Special Tax Notice and Reporting

Before making a distribution election, each participant must be given a “Special Tax Notice Regarding Plan Payments” which explains the tax consequences of distributions. Plan distributions are reported to the IRS on Form 1099-R which includes information concerning the type of distribution, taxable amount, taxes withheld and whether or not the 10% penalty is applicable.

Summary

Distribution decisions hold myriad consequences. Employees who do not consider the tax consequences may be in for a rude awakening when they complete their tax returns and discover that not only do they owe additional income taxes on the distributed amount but also a 10% penalty. Plan administrators need to be aware of these complex rules in order to communicate effective-

ly with participants seeking to take distributions from the plan.

2017 IRS Annual Limits

Each year the U.S. government adjusts the limits for qualified plans to reflect cost of living adjustments. Many of these limits are based on the “plan year.” The elective deferral and catch-up limits are always based on the calendar year. Here are the 2017 limits as well as the 2016 limits:

Limit	2017	2016
Maximum compensation limit	\$270,000	\$265,000
Defined contribution plan maximum contribution	\$54,000	\$53,000
Defined benefit plan maximum benefit	\$215,000	\$210,000
401(k), 403(b) and 457 plan maximum elective deferrals	\$18,000	\$18,000
Catch-up contributions	\$6,000	\$6,000
SIMPLE plan maximum elective deferrals	\$12,500	\$12,500
Catch-up contributions	\$3,000	\$3,000
IRA maximum contributions	\$5,500	\$5,500
Catch-up contributions	\$1,000	\$1,000
Highly compensated employee threshold	\$120,000	\$120,000
Key employee (officer) threshold	\$175,000	\$170,000
Social Security taxable wage base	\$127,200	\$118,500

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. Readers should not act or rely on any information in this newsletter without first seeking the advice of an independent tax advisor such as an attorney or CPA.

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190 North Wiget Lane • Suite 125 • Walnut Creek, California 94598

Telephone: 925.932.1800 • Fax: 925.932.1869 • Email: curtstoller@stollerco.com